STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

THE PEOPLE OF THE STATE OF ILLINOIS,	)	
***ex rel.* LISA MADIGAN, Attorney General of the**	)	
State of Illinois	)	
	)	
Complainants	)	**Docket No. 13-0511**
	)	
vs.	)	
	)	
COMMONWEALTH EDISON COMPANY	)	
Complaint to investigate and modify the Formula	)	
Rate Tariff established under Section 16-108.5	)	
of the Act	)	

DIRECT TESTIMONY OF DAVID J. EFFRON ON BEHALF OF THE PEOPLE OF THE STATE OF ILLINOIS

AG Exhibit 2.0

September 27, 2013

ILLINOIS COMMERCE COMMISSION
DOCKET NO. 13-0318
DIRECT TESTIMONY OF DAVID J. EFFRON
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I. STATEMENT OF QUALIFICATIONS

Q. Please state your name and business address.

A. My name is David J. Effron. My business address is 12 Pond Path, North Hampton, New Hampshire, 03862.

Q. What is your present occupation?

A. I am a consultant specializing in utility regulation.

Q. Please summarize your professional experience.

A. My professional career includes over thirty years as a regulatory consultant, two years as a supervisor of capital investment analysis and controls at Gulf & Western Industries and two years at Touche Ross & Co. as a consultant and staff auditor. I am a Certified Public Accountant and I have served as an instructor in the business program at Western Connecticut State College.

Q. What experience do you have in the area of utility rate setting proceedings and other utility matters?

A. I have analyzed numerous electric, gas, telephone, and water filings in different jurisdictions. Pursuant to those analyses I have prepared testimony, assisted attorneys in case preparation, and provided assistance during settlement negotiations with various utility companies.

I have testified in over three hundred cases before regulatory commissions in Alabama, Colorado, Connecticut, Florida, Georgia, Illinois, Indiana, Kansas, Kentucky, Maryland, Massachusetts, Missouri, Nevada, New Jersey, New York, North Dakota, Ohio, Pennsylvania, Rhode Island, South Carolina, Texas, Vermont, Virginia, and Washington.

Q. Please describe your other work experience.

A. As a supervisor of capital investment analysis at Gulf & Western Industries, I was responsible for reports and analyses concerning capital spending programs, including project analysis, formulation of capital budgets, establishment of accounting procedures, monitoring capital spending and administration of the leasing program. At Touche Ross & Co., I was an associate consultant in management services for one year and a staff auditor for one year.

Q. Have you earned any distinctions as a Certified Public Accountant?

A. Yes. I received the Gold Charles Waldo Haskins Memorial Award for the highest scores in the May 1974 certified public accounting examination in New York State.

Q. Please describe your educational background.

A. I have a Bachelor's degree in Economics (with distinction) from Dartmouth College and a Masters of Business Administration Degree from Columbia University.

II. INTRODUCTION AND SUMMARY OF TESTIMONY

Q. On whose behalf are you testifying?

A. I am testifying on behalf of the People of the State of Illinois as represented by the Illinois Attorney General ("AG") in support of the Complaint filed by the People on September 3, 2013.

Q. What is the purpose of your testimony?

A. I address certain issues related to the May 30, 2013 ComEd ICC tariff sheets and formula rate spreadsheets, filed with the ICC pursuant to Public Act 98-0015 and new Section 16-108.5(k)(1) of the Public Utilities Act, that triggered changes in ComEd's delivery services formula rate tariff and the subsequent rates incorporated into ComEd's formula rate update case, Docket No. 13-0318. In particular, I present modifications to the Return on Equity ("ROE") Collar Computation and to the method of calculating of interest on reconciliation adjustments. The changes I recommend to the formula rate tariff should be adopted by the Commission, as discussed below, so they can be incorporated into rates that take effect January 1, 2014 and thereafter.

III. ACTUAL RATE BASE TO BE USED IN COLLAR CALCULATION

Q. Has the Company presented its calculation of the earned return on equity ("ROE") in 2012 for the purpose of quantifying the ROE collar adjustment?

A. Yes. ICC Docket No. 13-0318, Schedule FR A-3 shows the Company's ROE collar computation. This methodology was also incorporated into the Company's May 30, 2013 filing in Docket No. 13-0386.

Q. Should the Company's method of calculating the actual earned ROE for the reconciliation year be modified?

A. Yes. The Company is proposing to use the rate base as of the end of the reconciliation year for the purpose of calculating the DS Common Equity Balance and fixed cost capital balances. That is, the Company uses the actual rate base as of December 31, 2012, based on the 2012 FERC Form 1 to quantify the balance of common equity used in the ROE computation and the interest and preferred dividends used in the quantification of the net income available for common equity. Rather than the end-of-year rate base, the average rate base for the year should be used in the calculation of the earned ROE for the purpose of the collar calculation.

Q. Why should the average rate base for the year be used in the calculation of the earned ROE?

A. Very simply, applying the common equity ratio to the average rate base will produce a dollar balance that correctly represents the actual capital supplied by equity investors to support the Company's rate base over the course of the year for which the ROE is being calculated. The net income used in the ROE calculation is the income earned over the course of the year, not the annualized net income being earned at the end of the year. To be consistent, the common equity balance used in the denominator of the ROE calculation should be the average balance of common equity over the course of the year. In times when the common equity balance is growing, using the end of period balance of common equity will understate the actual ROE earned on common equity provided by investors over the course of the year, and in times when the common equity balance is decreasing, using the end of period balance of common equity will overstate the actual ROE earned on common equity provided by investors over the course of the year.

Q. Why are you raising this issue at this time?

A. In the last legislative session, the General Assembly passed Senate Bill 9 ("SB 9"), enacted as PA 98-0015, which amended Section 16-108.5 of the Public Utilities Act. PA 98-0015 requires that the year-end rate base be used for the purpose of calculating the actual revenue requirement for the reconciliation year. Prior to the enactment of PA 98-0015, the Commission used the average rate base for the purpose of calculating both the reconciliation adjustment and the collar adjustment. Thus, the reconciliation adjustment accurately measured actual revenue requirement based on the average rate base for the reconciliation period. Notwithstanding the new requirement to use the year-end rate base in the reconciliation adjustment, the continuing use of the average rate base in the ROE collar calculation is necessary to accurately measure the ROE earned based on the actual equity investment over the course of the year.

Q. Can you illustrate by means of a simple example how use of the end of year common equity balance understates the actual earned return on equity when the common equity balance is growing over the course of the year?

A. Yes. Assume an investor opened a savings account at the beginning of the year and funded that account by contributing $100 per month over the course of the year. Assume further that the stated rate of interest on that account is 5%. At the end of the year, the investor will have contributed $1,200 to the account. However, he will have no claim to interest of $60, or 5% * $1,200. Rather, the interest earned would be $30, or 5% * $600, the average balance of the amount contributed for the year. If one calculated the effective interest rate by dividing $30 by $1,200, the result would be 2.5%. This obviously understates the effective interest rate actually earned by the investor. The same principle applies to the calculation of the earned ROE. If the earned ROE is calculated by dividing the net income by end of year equity balance over the course of a year when the equity investment is growing, the earned ROE will be understated.

Q. How should the rate base used in the ROE collar computation be modified?

A. On Schedule FR A-3, Line 1, as filed by the Company on May 30, 2013 in Docket No. 13-0386 and in Docket No. 13-0318, the Company uses the rate base from Schedule FR A-1- REC, Line 12 (the reconciliation year-end rate base) in the ROE collar computation. The simplest modification to incorporate the average rate base into the ROE collar computation would be to include the average of the rate base on Schedule FR B-1, Line 28 in the current year filing and the approved rate base on Schedule FR B-1, Line 28 in the prior year filing on Line 1 of Schedule FR A-3. Thus, the rate base used in the calculation of the 2012 ROE collar computation would be the average of the rate base on Schedule FR B-1, Line 28 in the present filing (the rate base as of December 31, 2012) and the rate base on Schedule FR B-1, Line 28 as of December 31, 2011 as approved by the Commission.

Q. What was ComEd's average rate base and earned ROE for 2012?

A. The Commission approved a 2011 year-end rate base before projected plant additions of $6,025,672,000 in ComEd's last formula rate Order (ICC Docket 12-0321). ComEd reported a 2012 year-end rate base of $6,390,272,000 on Schedule FR A-1 REC in Docket No. 13-0318 which is reduced to $6,381,327,000 after my proposed adjustments. The average rate base for 2012 is $6,203,500,000. The ROE resulting from this calculation is 9.75% (AG Exh. 2.1, page 1 of 2, Sch. FR A-3-DJE). The ROE collar adjustment on Schedule FR A-1 is $(25,308,000) (AG Exh. 2.1, page 2 of 2, Sch. DJE-3) as compared to the Company's ROE collar adjustment of $(6,395,000), with the amounts in parentheses signifying earnings in excess of the collar's range. Thus, this adjustment results in a reduction to the Net Revenue Requirement on Line 36 of Schedule FR A-1 in Docket No. 13-0318 of $18,913,000, exclusive of any interest.

IV. CALCULATION OF INTEREST ON RECONCILIATION ADJUSTMENTS

Q. How does the Company calculate interest on the reconciliation adjustment?

A. As can be seen on ICC Docket No. 13-0386, Schedule FR A-4, and in Docket No. 13-0318, Schedule FR A-4 (attached to my testimony as AG Ex. 2.2 and also designated as AG Complaint Ex. 4), the Company calculates interest by applying the weighted average cost of capital to the monthly balance of the reconciliation adjustment.

Q. Are you proposing to modify the method of calculating interest on reconciliation adjustments?

A. Yes. The interest should be calculated on the reconciliation adjustment, net of applicable deferred income taxes.

Q. Why are you proposing this modification?

A. Carrying charges should be calculated on the net cash investment in the deferrals when the reconciliation adjustment is a debit balance (or on the net source of funds provided by the over-recovery when the reconciliation is a credit balance). If a particular cost is deductible for income tax purposes as incurred, then the net cash investment to fund the deferred recovery of such a cost is reduced by the income tax savings associated with the tax deduction, and the carrying costs should reflect this reduction to the net cash requirement. For example, if a cost of $1,000 is deferred for future recovery from customers but that cost is deductible for income tax purposes as incurred and the combined state and federal income tax rate is 40%, then the cost will reduce income tax expense by $400 (40% * $1,000). The net cash to carry the deferral is $600 ($1,000 - $400), and only this net balance should serve as the basis on which carrying costs are accrued. The same logic applies when the reconciliation adjustment represents a credit balance owed to customers.

Q. Has the Commission previously addressed this issue?

A. Yes. In Docket No. 11-0721, ComEd's first formula rate filing, the Commission declined to offset deferred taxes against the reconciliation balance on which interest is calculated, finding that "ComEd contends that this recommendation does not provide ComEd with cash. AG/AARP provide little information establishing that this procedure is within generally accepted accounting procedures, or that it would be of benefit to ComEd or to ratepayers." Order at 167.

Q. Do deferred taxes on the reconciliation balance represent actual cash to the utility when the reconciliation is a debit balance?

A. Yes. To the extent that the reconciliation represents an under-recovery, the current income tax expense is lower than it would have been in the absence of the under-recovery. The relevant income taxes are not actually paid until the reconciliation balance is recovered. The deferral in the payment of income taxes is a real cash benefit and should be recognized in the calculation of interest on the reconciliation balances.

Q. Is offsetting applicable deferred income taxes against the reconciliation balance on which interest is accrued within generally accepted accounting procedures?

A. Mr. Brosch addresses generally accepted accounting procedures applicable to this issue. I can state that calculating the interest on the net cash investment (or net source of funds) is most definitely consistent with all ratemaking principles with which I am familiar and certainly does not violate any generally accepted accounting procedures.

I would further note that the Company itself records deferred taxes on the regulatory asset associated with the under-recovery of its revenue requirements (response to AG Data Request 1.04 in Docket No. 13-0318, attached to my testimony as Exhibit 2.3). The existence of these deferred taxes must be recognized, and the appropriate method to do so is to offset the applicable deferred income taxes against the regulatory asset (or regulatory liability) related to the reconciliation balance on which interest is calculated.

Q. Would offsetting applicable deferred income taxes against the reconciliation balance on which interest is accrued be of benefit to the utility?

A. When the reconciliation balance is a credit balance, offsetting applicable deferred income taxes against the reconciliation balance on which interest is accrued is of benefit to the utility, because the utility is then required to credit customers for interest on only the net source of funds provided by the over-recovery.

Q. Would offsetting applicable deferred income taxes against the reconciliation balance on which interest is accrued be of benefit to ratepayers?

A. When the reconciliation balance is a debit balance, offsetting applicable deferred income taxes against the reconciliation balance on which interest is accrued is of benefit to ratepayers, because the utility then recovers interest on only the net use of funds required by the under-recovery.

Offsetting the deferred taxes against the reconciliation balance when calculating interest avoids crediting interest on funds that the utility is not holding or recovering interest on an investment that it does not have. In this regard, it is fair to both the utility and ratepayers.

Q. Has anything changed since the formula rate application originally filed by the Company in ICC Docket No. 13-0318 that increase the significance of this issue?

A. Yes. Previously, the Commission had ordered the use of the short-term debt rate in calculating the interest on reconciliation adjustments. Because the short-term debt rate has recently been so low, the interest accrued on reconciliation adjustments was relatively immaterial, and the difference between the interest on the pre-tax reconciliation adjustment and the after-tax reconciliation adjustment was relatively negligible. However, since the passage of PA 98-0015, the utilities are required to use the weighted average cost of capital in calculating interest on the reconciliation adjustments. Because the weighted average cost of capital is so much higher than the interest rate on short-term debt, the interest on the reconciliation adjustment is no longer immaterial. The Commission should ensure that the interest either credited to customers or recovered from customers is limited to the interest on the net source or use of funds related to the reconciliation adjustment.

Q. Does this conclude your direct testimony?

A. Yes.